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COORDINATED ISSUE
ALL INDUSTRIES
AMORTIZATION OF MARKET BASED INTANGIBLES

ISSUE:

Whether a benefit derived from a favorable market position is an amortizable asset and, if so, how the useful life and value of the asset can be determined.

BACKGROUND:

Market based intangibles emanate from the notion that an acquired business presently has a competitive advantage in the market that will diminish as more competition enters the market, or that the business will enjoy future growth in its market position.

Generally, market based intangibles can be classified in one of two categories:

* **Existing market share intangibles** represent the present value of unusually high profits or high level of market share, generally due to a lack of competition in the market area. The life and value of such an intangible is determined by studies predicting both the timing of increased competition and its impact on earnings. Thus, the existing market share intangible is based on the notion that the taxpayer's market share, but not necessarily total revenues, will decline as more competition enters the market. An example of an existing market share intangible is the "underdeveloped CATV market" intangible.

* **Future market share intangibles** represent the present value of projected increases (i.e., future growth) in the market. Such intangibles reflect expectations of future growth of the enterprise, based on assumptions of future inflation, projections of local population growth, ability to increase market penetration, etc. These intangibles represent an attempt to amortize the future growth of a business rather than the limited usefulness of a present asset

Market based (or market share) intangibles arise in the context of a stock acquisition that is followed by a step-up in basis of the assets of the acquired corporation under former I.R.C. § 334(b)(2) or section 338. These intangibles may also be claimed in the context of an asset acquisition where a lump sum purchase price paid for the acquired business is allocated among the various component assets of the business. Stock and asset acquisitions typically involve the payment of a premium over the net fair market value of the tangible assets of the acquired corporation or business. To minimize the amount allocated to goodwill and going concern value, a taxpayer may allocate a large amount of the purchase price to various intangible assets and attempt to amortize them. Some of these intangibles are based upon the taxpayer's market position. For example, in the Media Industry, companies that operate radio and television stations have claimed an intangible known as "accelerated market growth asset," which represents the present value of projected increases in broadcast revenues attributable to the projected growth in the population or number of households in the market area. Another example is the "underdeveloped cable television market asset," which represents the present value of the increased revenues from lack of cable-sourced additional competition in the market area; the obsolescence or diminishment of this asset is based on the notion that market share (but not necessarily revenues) will decline as competition enters the market. Another example is "single ownership markets" (the value inherent in being the only business of its kind in the market). While many of the market based intangibles that the Service has identified arise in the Media Industry, they could arise in almost any industry.

DISCUSSION:

The purpose of this paper is to explain how to deal with a taxpayer's amortization claim for a market based intangible asset relating to taxable periods prior to the enactment date of I.R.C. § 197 (August 10, 1993). Historically, the Service took the position that market based intangibles were nonamortizable as a matter of law. However, recent developments in the case law make it clear that the amortization of any intangible asset is a question of fact, requiring both the Service and the taxpayer to develop the issue in terms of useful life and value.

The Two-Prong Test for Amortization

I.R.C. § 167(a) is the controlling provision for the allowance for amortization of intangible assets acquired prior to the enactment date (or election-back date, where applicable) of section 197. Although section 167(a) does not specifically refer to intangible property, Treas. Reg. § 1.167(a)-3 recognizes that an intangible asset may be depreciated[1] if the asset is known from experience or other factors to be of use in the business or in the production of income for a limited period, the length of which can

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[1] "Depreciation" and "amortization" are used interchangeably. Generally, "depreciation" refers to an allowance for the wear, tear, exhaustion or obsolescence of a tangible asset. "Amortization" refers to the periodic recovery of the cost of an intangible asset. Both terms, however, describe the same concept, cost recovery, for which authority is found in I.R.C. § 167(a).

be estimated with reasonable accuracy. The regulation denies amortization for intangible assets which do not have limited useful lives, and states specifically that no depreciation is allowable for goodwill. By implication, this provision extends to going concern value as well. See United States v. Cornish, 348 F.2d 175 (9th Cir. 1965). Goodwill and going concern value are nondepreciable as a matter of law because of the difficulties inherent in the computation of their decline and because their initial value is difficult to appraise. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974); Dodge Brothers v. United States, 118 F.2d 95 (4th Cir. 1941); United States v. Cornish, supra (going concern value is nonamortizable as a matter of law).

The Service historically took the position that market based intangibles were not amortizable as a matter of law because any value that an advantageous market position possesses was inextricably linked either to the customer structure of the business and the taxpayer's expectation of its ability to attract anticipated customers while retaining current patronage (i.e., "goodwill"), or was a competitive advantage enjoyed by the acquired business due to a market condition which could not be easily replicated, such as lack of competition or favorable market share (i.e., "going concern value").

However, the Service has modified its position as the result of the Supreme Court's opinion in Newark Morning Ledger Co. v. United States, 507 U.S. __, 113 S. Ct. 1670, 123 L.Ed.2d 288 (1993), rev'g 945 F.2d 555 (3d Cir. 1992), rev'g 736 F. Supp. 176 (D.N.J. 1990). In Newark Morning Ledger, the Court held that

> a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.

113 S. Ct. at 1681 (emphasis supplied). The Supreme Court reasoned that if a taxpayer is able to establish that an intangible asset can be valued and that it has a reasonably estimable limited useful life, then the asset is necessarily separate and distinct from goodwill. "The entire justification for refusing to permit the depreciation of goodwill evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time." 113 S. Ct. at 1680.

The opinion in Newark Morning Ledger is very broad and cannot be limited to customer based intangibles, nor should it be read as limited only to assets in the nature of goodwill. There is no legal justification for not extending the holding to assets in the nature of going concern value, as the Fourth Circuit recognized in Ithaca Industries, Inc. v. Commissioner, 17 F.3d 684 (4th Cir. 1994), aff'g 97 T.C. 253 (1991).

Therefore, the test for whether any intangible asset (including market based intangibles) is amortizable is two pronged: (1) Can the taxpayer establish that the asset has a limited useful life, and (2) has the taxpayer established the value of the asset with reasonable accuracy? If both of these elements have been established, the value of the asset may be depreciated over its useful life.

Both prongs of the Newark Morning Ledger test are strictly factual determinations. For this reason, the Service has to factually develop cases involving market based and other intangibles, or else expect to lose these cases. In Newark Morning Ledger, for example, the government did not challenge the taxpayer's factual evidence of useful life and value of the asset, relying instead on the argument that amortization should be disallowed as a matter of law because the "paid subscriber base" represented the goodwill of the acquired newspapers. Because the government had not developed the case factually, the government lost the case once the Supreme Court had announced that depreciability of an intangible asset is a question of fact. The taxpayer, having been the only party to introduce evidence, met its burden of proof.

The Burden of Proof

It is clear from the majority opinion in Newark Morning Ledger that a taxpayer claiming amortization of an intangible asset has a substantial burden to establish (1) that the taxpayer has accurately determined the anticipated useful life of the claimed value of the asset, and (2) that the taxpayer has accurately determined its value. The Court acknowledged that

> Although we now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life ... , we do not mean to imply that the taxpayer's burden is insignificant. On the contrary, that burden will often prove too great to bear.

113 S. Ct. at 1681.

The heavy burden of establishing a useful life with sufficient accuracy is illustrated by Ithaca Industries, Inc. v. Commissioner, supra, 17 F.3d 684. The issue in Ithaca Industries was whether the taxpayer could depreciate an "assembled workforce." The Service took the position that the value inherent in the workforce was, as a matter of law, nonamortizable going concern value. The Tax Court rejected the Service's argument, but the government nevertheless prevailed when the court found as a factual matter that the taxpayer had not established that an assembled workforce has a limited useful life. As proof of the limited useful life of the assembled workforce, the taxpayer had offered statistical data that purported to measure the rate at which the employees in the acquired workforce could be expected to terminate their employment. The Tax Court found this analytical approach was flawed. "The rate at which the individual employees who make up the work force on a specific day will leave their jobs is not a determination of the length of time an assembled work force will be an intangible asset of the business." 97 T.C. at 272.

The Fourth Circuit affirmed, but upon different grounds. Where the Tax Court had found that the assembled workforce was a nonwasting asset, the Fourth Circuit believed that the asset began to decline as a result of resignations, terminations, retirements, and deaths of individual workers. After analyzing the statistical evidence that the taxpayer had offered, however, the Fourth Circuit concluded that the data did not accurately measure the useful life of the assembled workforce. The court noted that the decline rate of a workforce is susceptible to a number of variables, constantly changing, and out of the control of the taxpayer. These influences, operating both in and out of the workplace, "inject[] vagaries into the useful life analysis." 17 F.3d at 690 n.15. The characteristics of the asset, in other words, "suggest no sufficiently accurate means of estimating its useful life." 17 F.3d at 690.

Ithaca Industries demonstrates that the courts demand well-founded proof of useful life. Because both the Tax Court and the Fourth Circuit found that the taxpayer in Ithaca Industries had not met its burden of establishing useful life, neither court had to address the second prong of the Newark Morning Ledger test: whether the value of the asset had been established with reasonable accuracy. It is worth noting, however, that the Fourth Circuit intimated that the taxpayer's method of valuing the assembled workforce was insufficient.

Application to Market Based Intangibles

The test for depreciability is factual. It is conceivable that a taxpayer can establish the useful life and value of a market based intangible. However, taxpayers must overcome the stringent proof requirements and their statistical data must withstand critical analysis.

Market based intangibles have inherent characteristics which, like the workforce intangible in Ithaca Industries, make them insusceptible to sufficiently trustworthy statistical measurement. Market based intangibles represent an attempt by taxpayers to carve out some portion of a total market base or favorable market position as subject to obsolescence due to competitive pressures. The difficulty in measuring the limited life of a competitive advantage lies in the fact that the taxpayer's data necessarily speculates about future events. Changes in current market share or competitive position, or increasing or decreasing revenues due to growing or declining markets, is a function of a number of factors, such as access to the market, economic and competitive climate of the business, ability to adapt to economic, competitive and technological changes, and the underlying demographics in the market locale. Thus, any statistical methodology lacking controls for each of these factors suffers from the same shortcomings as the taxpayer’s evidence in Ithaca Industries.

A further issue exists, but it should be raised only as an alternative ground for disallowance. Market based intangibles differ from other intangible assets in that the taxpayer usually lacks a property interest in the "benefit" enjoyed by the advantageous market position. In order to claim the depreciation deduction, the taxpayer must demonstrate that the asset is **used** in the taxpayer’s trade or business or **held** for the production of income. Competitive advantage may be a benefit enjoyed by the taxpayer who acquires a well-positioned going concern, but it is neither used nor held by the taxpayer.

Assuming that a taxpayer can demonstrate that an existing market share intangible meets the Newark Morning Ledger test, and can substantiate its useful life and value, amortization may be permitted. Amortization will not be permitted merely because, in the taxpayer’s unsupported opinion, the intangible asset has a limited useful life. Treas. Reg. § 1.167(a)-3. Substantiation must be provided in the form of a properly supported and independent appraisal.

Useful Life

The fact that the market based intangible has a limited useful life must be demonstrated by the taxpayer. Additionally, the duration of the useful life must be established. **The life which is relevant for amortization purposes is the actual, entire life of the asset, and not its average life.** Where statistical methods have been used to project the life of an intangible asset, the statistical projection should be compared with the taxpayer's actual post-acquisition experience. Lifing studies should, where possible, be reviewed by a statistician to identify lifing methodologies that are inconsistent with general statistical principles.

The taxpayer may not ignore the above-normal life of certain stable customer relationships, such as commercial accounts or long-term supplier relationships.

Valuation

With the exception of the core deposit cases, the government has focused more on whether the intangible asset is amortizable as a legal matter and less on whether the taxpayer's asserted value and life are accurate. Taxpayers now have an even greater incentive to allocate a large percentage of the purchase price to intangible assets, with the result that the Service must now focus its resources on challenging those valuation and useful life contentions.

In Newark Morning Ledger, the Supreme Court sanctioned the **income approach** for valuing customer-based intangibles. This approach is an appraisal methodology that measures the present value of future net income to be received from the customers existing on the date of acquisition, over the useful life of the asset. Because market based intangibles seek to measure revenues to be received from future customers, the income method can generally be applied to this type of asset as well. The income stream attributable to a market based intangible:

* Must be determined based on the actual full term of the income stream, not its average life.

* Must be net.

* Must not include the return on any other asset (no double counting).

* Must be consistent with all other valuation assumptions made by the taxpayer.

* Should consider only income from future customers of the acquired concern on the acquisition date; **the income stream should not reflect income attributable to current customers**.

* Should include an after-tax discount rate that reflects the speculative nature of the asset (i.e., should reflect a higher discount rate for more speculative assets), and should use a higher discount rate for the specific asset as compared to the discount rate appropriate in valuing the business as a whole. If the rate used is not at least as high as the taxpayer's actual return on equity, further inquiry will be necessary.

* Should not be increased by an inflation factor.

* Should identify the costs (both direct and indirect) identifiable with the asset being valued.

Net after-tax cash flow may include a "tax shield," i.e., the present value of the tax savings attributable to the amortization deduction. See IT&S of Iowa, Inc. v. Commissioner, 97 T.C. 496 (1991), and Peoples Bancorporation v.Commissioner, T.C. Memo. 1992-285, where the court sanctioned the use of a tax shield. The after-tax cost savings may be computed in either of two ways. In Citizens & Southern and Colorado National Bankshares, for example, an effective tax rate of 20% was applied to cost savings unreduced by the amortization deductions. Alternatively, the statutory tax rate can be applied to the cost savings reduced by the amortization deductions. However, be alert to a flawed computation which applies an effective tax rate to costs savings reduced by the amortization deductions because the tax benefit of amortization is already included in the effective tax rate. IT&S of Iowa, Inc. v. Commissioner, supra, 97 T.C. at 532-533. See, e.g., Trustmark Corp. v. Commissioner, T.C. Memo. 1994-184.

Amortization Method

On the assumption that a market based intangible can be substantiated, the **straight line method** is generally acceptable as an amortization method. If an accelerated method is used, it must be consistent with the rate at which the asset itself (not its present value) is projected to waste for valuation purposes.

Potential for Double Counting

Customer based intangibles are frequently mischaracterized as market based intangibles, as both seek to value revenues to be received from customers, advertisers, or subscribers of the acquired business. If this is the case, care must be taken to ensure that the value of customer based revenue flows (i.e., future income derived from current customers) is not also included in the valuation of the market based intangible (i.e., revenue flows attributable to future customers).

I.R.C. § 1253

Where the acquired business is subject to a license or franchise, the Service recognizes that some market based intangibles are encompassed within franchise value, and thus may be amortizable pursuant to former section 1253(d)(2), which was repealed by the Omnibus Budget Reconciliation Act of 1993 for transactions occurring on or after August 10, 1993.

Treatment of Market Based Intangibles Under Section 197

Amortization and useful lives of market based intangibles will not be issues for transactions occurring after August 10, 1993, the date of enactment of new Code section 197. Section 197 provides for 15-year straight line amortization of certain acquired intangible assets (called "section 197 assets") beginning with the month of acquisition. No other deduction for depreciation or amortization is allowed for section 197 assets. Except for a limited election for intangibles purchased after July 25, 1991, and on or before August 10, 1993, the legislation is not retroactive. The definition of "section 197 assets" includes market based or market share intangibles and any other assets resulting from the future provision of goods or services pursuant to customer relationships.

Valuation will continue to be an issue, however, as taxpayers may attempt to overstate the values of tangible assets with shorter recovery periods, and undervalue their intangibles.

EXAMINATION POSITION:

In view of the Supreme Court's holding in Newark Morning Ledger, it is not appropriate to view market based intangibles as nonamortizable as a matter of law. A market based intangible asset may be amortizable if, after factual development, the asset is shown to have a limited useful life and its value can be established with reasonable certainty. However, this is not an easy task for taxpayers. The taxpayer must be able to (1) identify the claimed asset, and demonstrate that it does not overlap with other putative intangibles claimed on the return; (2) demonstrate that the market based intangible has a useful life of limited duration, and the useful life can be established with reasonable certainty; (3) demonstrate the asset's value with reasonable accuracy, with substantiation in the form of a proper appraisal; and (4) establish that its method of amortization is a reasonable one.

Because a case involving a market based intangible requires factual development, examining agents are urged to consult a Service engineer or economist (or an outside expert in appropriate cases) for lifing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to the claimed useful life and valuation, the Service should always be able to specifically demonstrate why a taxpayer's appraisals or assertions are erroneous. General guidance on critiquing taxpayers' appraisals may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N.